Supreme Court, U.S.
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No. 09-1113

IN THE

Supreme Court of the United States

JEFFREY W. BADER,

Petitioner,

v.

LLOYD BLANKFEIN, ET AL.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF

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I. The Second Circuit Stood Delaware Law On Its Head

The respondents argue that the Second Circuit did not blatantly nullify Delaware law. They contend that the Second Circuit did not strike down Delaware law and did nothing egregious.[1] Instead, the respondents argue, the Second Circuit applied and enforced Delaware law. The respondents are wrong.

Delaware is where most of the U.S. publicly held corporations are incorporated. Unsurprisingly, Delaware takes a great interest in matters of corporate law and governance. The Delaware Supreme Court holds that stockholders' derivative actions are an important part of corporate life and that such actions are one of the "potent tools to redress the conduct of a torpid and unfaithful management." *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

The Delaware pre-suit demand rule and its exceptions are indispensible to the Delaware way of corporate life, and to the way of corporate life for the many states that have a futility exception to the demand

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[1] The respondents cite *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984), to say that, under the *second* prong of *Aronson*, conduct must be egregious on its face to be unprotected by the business judgment rule and that there is nothing egregious about a disclosure violation. The respondents misread *Aronson*, which was addressing the *first* prong of *Aronson*, and the question of whether a board's conduct was so wrongheaded as to create a substantial risk of liability and to make them interested under the first prong.

rule. *In re PSE&G Shareholder Litigation*, 173 N.J. 258, 278-79, 801 A.2d 295, 307-08 (2002) (most jurisdictions will excuse demand if making it would be futile). The issue at bar is one of broad application, not only to the many Delaware corporations, but also to the many states that follow or accept guidance from Delaware corporation law. Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands – Reprise*, 28 CARDOZO L. REV. 1287, 1287-88 (2006) (American courts look to Delaware's "rich abundance of corporate law." Delaware court system is the "Mother Court of corporate law.")

The Second Circuit's decision was not just a "state-law [mis]determination by the Court of Appeals." *Haring v. Prosise*, 462 U.S. 306, 314 n.8 (1983). Nor was it a "reasonable construction of state law." *Id.* Nor was it a mere "misapplication of a properly stated rule of law," as contemplated in Rule 10 of the Supreme Court Rules. Rather, the Second Circuit's decision stood Delaware law on its head and subverted a long-standing rule, carefully worked-out by the Delaware courts.

At bar, the excusal of demand may be expressed as a major premise, a minor premise, and a conclusion. The major premise is that Delaware law excuses pre-suit demand in a stockholder's derivative suit where the complaint alleges a reasonable doubt that the challenged transaction is the product of a valid exercise of business judgment. *Aronson v. Lewis*, 473 A.2d at 814.

The minor premise is that disclosure of false information cannot be the product of the valid exercise

of business judgment, particularly where the disclosure affects such a fundamental matter as stockholder voting for directors. This is not just a Delaware rule expressed in *In re Anderson, Clayton Shareholders' Litigation*, 519 A.2d 669, 675 (Del. Ch. 1986). It is universally accepted. 3 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1040 n.15, 16, 17 (2009); 1 DENNIS J. BLOCK, NANCY E. BARTON, STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE : FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS, 41, 508-10 (5th ed. 1998).

The conclusion is that pre-suit demand is excused under Delaware law where the challenged transaction is the distribution of a false proxy statement that solicits stockholder votes.

The respondents argue that authorities such as *Anderson, Clayton* do not apply at bar because they do not hold, *in haec verba*, that pre-suit demand is excused, only that, in other contexts, false proxy statements are not protected by the business judgment rule. In this connection they cite *In re Tri-Star Pictures, Inc., Litigation*, 1990 WL 82734 at *8 (Del. Ch. June 14, 1990), from which they quote, "if the disclosure claims were derivative, they would be subject to the demand requirement." (Opp. at 9.) That quote elides the language that makes the respondents' argument false. That quote, in context, is:

> [I]f the disclosure claims were derivative, they would be subject to the demand requirement of Rule 23.1, which is rooted in business judgment rule considerations. *Aronson v.*

> *Lewis*, 473 A.2d 805, 812 (Del. Supr. 1984). Yet, that result would be inconsistent with Delaware case law holding that the business judgment rule does not apply to "... the question whether shareholders have, under the circumstances, been provided with appropriate information upon which an informed choice on a matter of fundamental corporate importance may be made. . . ." *In re Anderson, Clayton Shareholders' Litigation*, 519 A.2d 669, 675 (Del. Ch. 1986).

What the *Tri-Star* court was saying was that under *Anderson, Clayton* pre-suit demand is excused in a stockholder's derivative suit where the challenged transaction is a false proxy statement, which is not protected by the business judgment rule.

A recent Delaware Chancery Court case illustrates the point. In *Weiss v. Swanson*, 948 A.2d 433, 441-48 (Del. Ch. 2008), the court excused demand, holding that the board's timing of stock option grants to precede good corporate news and to follow bad corporate news and its failure to disclose that conduct were not protected by the business judgment rule. The court held that failure to report those practices were material omissions in a proxy statement for stockholders "in deciding whether to . . . re-elect board members." *Id.* at 433 (footnote omitted). The *Weiss* opinion is replete with references to inadequacies in the proxy statements as grounds to excuse demand. The court addressed the second prong of *Aronson* and held that there was a reasonable doubt that these option grants and the omitted disclosures concerning their timing were the result of a valid exercise of business judgment.

The respondents argue that the Second Circuit came to the correct decision on pre-suit demand in that it was in accordance with the overwhelming majority of federal district courts, four in number, cited in footnote 5 of their brief, compared to one case in the petitioner's favor. *Vides v. Amelio*, 265 F. Supp. 2d 273 (S.D.N.Y. 2003). Three of those four cases do not address the second prong of *Aronson*, and the fourth does, but gets it wrong. That fourth case, *St. Clair Shores Gen. Employees' Ret. System v. Eibeler*, 2006 WL 2849783 at *4-7 (S.D.N.Y. Oct. 4, 2006), held that even though the board's conduct was not protected by the business judgment rule, the board had the business judgment to decide to bring or reject the case. That ruling is the opposite of Delaware law.

The correct decision was in *Vides v. Amelio*, which cited *Tri-Star* and *Anderson, Clayton*, and held that since a false proxy statement is not protected by the business judgment rule, pre-suit demand was excused under Delaware law. The *Vides* court cited *Katz v. Pels*, 774 F.Supp. 121, 127, n.5 (S.D.N.Y. 1991), and *Estate of Detwiler v. Offenbecher*, 728 F.Supp. 103, 150, n.18 (S.D.N.Y. 1989), which also held that pre-suit demand was excused under Delaware law where a stockholder's derivative action challenges a false proxy statement. In accord is the decision by Judge Farnan in *Seinfeld v. Barrett*, 2006 WL 890909 at *3 (D. Del. Mar. 31, 2006).[2]

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[2] The Second Circuit did not address federal policy. In *Vides v. Amelio*, 265 F.Supp. 2d at 276, the court held that, in addition to Delaware law, the federal interest in enforcing the federal securities laws was sufficient to excuse demand. In *In re Westinghouse Securities Litigation*, 832 F.Supp. 989, 997-98 (W.D. Pa. 1993), the complaint alleged stockholders' derivative (Cont'd)

II. The Case At Bar Is Not Moot

The respondents contend that the Second Circuit should have dismissed this case as moot, but that it did not do so because it found that the alleged wrong "is capable of repetition, yet evading review." *Bader v. Blankfein*, 2009 WL 4822818 at *1 (2d Cir. Dec. 14, 2009) (Citation omitted) (Pet. App. 3a). The respondents say that the regulation at issue here "has been superseded," so that the wrong is not capable of repetition. (Opp. fn 4.) The respondents omit to say that the Second Circuit addressed the change in the regulation and disagreed, saying:

> While we recognize that the particular SEC regulation at issue in plaintiff's claims is no longer in effect, the underlying alleged wrongful conduct – providing misleading calculations in proxy statements under section 14 – is a wrong that is "capable of repetition, yet evading review." *Heldman*, 962 F.2d at 157 n.9. Plaintiff's appeal is, therefore, not moot.

Bader v. Blankfein, 2009 WL 4822818, at *1 (Pet. App. 3a). The change in the regulation was to restrict the

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(Cont'd)
claims based on breach of fiduciary duty and false proxy statements. The court held that the business judgment rule does not apply to violations of the federal securities laws. It also held that disclosure duties are independent of duties concerning the management of corporate affairs. It further held that, regardless of the directors' independence, demand on the board is excused as a matter of federal policy, where the complaint alleges a violation of § 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a). *Id* , at 997-98.

disclosure to the present value of stock options and to eliminate the choice of disclosing the potential realizable value of stock options. (Pet. App. at 33a.)

The respondents also argue that the issues in this case will not evade review because the petitioner has filed two other cases, in 2008, similar to the instant case. They omit to say that in one of those cases they have moved to dismiss on the grounds that it, too, is moot.[3] As the respondents see it, this issue will always be moot because it is impossible to finish a case before the board's term expires. But, as the court held in *Bader v. Goldman Sachs Group, Inc.*, 311 Fed. Appx. 431 at *1 (2d Cir. Feb. 23, 2009), while some parts of the case are moot, e.g., seeking a preliminary injunction, others are not. The court said "[T]he district court has retained jurisdiction over plaintiff's underlying claim, which it will consider on the merits in due course." *Id.* at *1 (citation omitted).

III. The Petitioner's Counsel Of Record Does Not Have A "Pet Theory" Of Stock Option Valuation

Finally, the respondents say that the petitioner's counsel of record has taken the case at bar as part of his "pet theory regarding options – valuation disclosure." In three years of litigation, the respondents have raised this "pet theory" theory, but they not been able, and are still are unable to articulate what that pet theory is.

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[3] The other case does not seek to excuse demand based on a false proxy statement, so the precise pre-suit demand issue at bar will not arise.

All of those cases cited in footnote 1 are materially different from the case at bar. At bar, the complaint alleges that the proxy statement falsely reported the value of stock options *previously* granted to senior officers in connection with a vote to elect directors, in violation of 17 C.F.R. § 229.402(c)(2)(vi)(B) (Pet. App. at 33a), and 17 C.F.R. § 240.14a-9 (Pet. App. at 35a). In those footnote 1 cases, by contrast, the complaints alleged that where the proxy statements solicited stockholder approval of proposed stock option plans for options to be granted for years *in the future*, the proxy statements should report the Black-Scholes present value of all the options to be granted in the plans. But, the SEC did not and does not specifically require Black-Scholes values, 17 C.F.R. § 240.14a-101 (Item 10), which is why the footnote 1 cases were dismissed. Other SEC regulations, however, provided for reporting Black-Scholes values for stock options that *had been granted*, 17 C.F.R. § 229.402(c)(2)(vi)(B) (2006) (Pet. App. at 33a), relevant at bar, but not for stock options that *might be granted in the future*, not relevant at bar. The courts held that in the absence of a specific SEC requirement to report Black-Scholes values, such disclosure was not required.

CONCLUSION

Nearly all stockholders' derivative actions challenging proxy statements are brought in federal court because the applicable statute, § 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa, provides for exclusive federal jurisdiction. Such actions, if brought in state courts, must proceed without the protection of § 14(a) of the Exchange Act, 15 U.S.C. § 78n(a), and the rules and regulations of the United States Securities and Exchange Commission. Because issues of state corporation law inevitably arise, the federal courts must accept state law as it actually is and reject their own ideas of what that state law should be. At bar, the Second Circuit got Delaware law so wrong that it blatantly nullified it. The Supreme Court should grant the petition for writ of certiorari.

Respectfully submitted,

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